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SUBJECT: ESTONIAN CENTRAL BANK CITES SIGNS OF
OVERHEATING

¶1. (U) Summary: On June 14, Central Bank Governor Andres Lipstok warned of signs of overheating in the Estonian economy, announcing that wage growth was twice as large as productivity growth in the first quarter of 2006. He urged the GOE to forego a planned supplementary budget and recommended using the estimated 3 billion kroon (about $250 million) budget surplus to prop up reserve funds such as the pension fund. He also urged the public to curb consumption which is being fueled by record numbers of housing loans. Reaction to the Central Bank warning was subdued as the Ministry of Finance continued its plan for the supplementary budget (part of which will be directed toward the pension fund). Major banks continue to state that the economy's fundamentals are good, even if inflation numbers call into question Estonia's ability to meet Maastricht criteria for euro adoption in the near future. End Summary.

¶2. (U) Central Bank Governor Lipstok gave a briefing about the Estonian economy shortly after his meeting with Treasury U/S Timothy Adams June 14 (reftel). Lipstok cited newly-released first quarter economic figures which showed that growth in real wages was more than double productivity growth. He said that while Estonia's first quarter economic growth was more than 11 percent, "the situation is not as rosy as the figures show." He noted that export growth slowed somewhat in the first quarter, meaning that the high growth was fueled by wage increases and domestic demand. He urged consumers to curb their hunger for easy credit, particularly housing loans, which were issued in record numbers in May. Lipstok also urged the GOE to forego a supplementary budget and instead use its expected 3 billion kroon (about $250 million) budget surplus to increase reserves such as the pension fund.

¶3. (SBU) Reaction to the Central Bank's announcement was muted. The Ministry of Finance continued with its plans for a supplementary budget, some of which will be directed to the pension fund. The two leading banks announced that while May saw a record number of housing loans, the high season for such loans would end in June and then lending would drop off. The CEO of Hansapank, Estonia's largest bank, told econoff June 16 that his bank viewed the Central Bank's warning as a message directed at politicians who might be tempted to boost spending in the run-up to presidential elections in the fall and parliamentary elections in spring. He said the fundamentals of the Estonian economy are strong, as are the balance sheets of Estonian banks. He added that contrary to the Central Bank's warning, in Hansa's view the Estonian public is not over-extended.

¶4. (U) Conclusions from an April IMF staff visit

underscored the strong fundamentals of the Estonian economy, noting the country has achieved nominal convergence under its euro-linked Currency Board Arrangement and has maintained a history of fiscal surpluses and low interest rate spreads. It stated that Estonia's plan to limit inflation to within Maastricht criteria bounds by re-phasing planned increases in excise taxes has a good change of succeeding, as long as the GOE maintains a strong fiscal posture. Estonia now hopes to adopt the euro on January 1, 2008, but many analysts are saying this target could be postponed by one to two years given continued expectations for strong growth accompanied by higher inflation, in the next few years.

¶5. (SBU) Comment: Current trends in growth and wage increases appear unsustainable. Foreign investors are already talking about canceling plans for expansion due to rapid wage growth and a growing labor shortage. Still, Estonia's fundamentals are sound. Public sector debt is the lowest in the EU, and with budget surpluses running over one and a half percent of GDP it will be politically difficult to argue that yet more fiscal discipline is required to reduce inflationary pressure. Though experts widely expect some bumps along the way (despite a recent plateau the potential for a real estate bubble is present), we believe the benign view of a gradual deceleration in GDP growth to the longer-term potential of approximately seven percent remains the most likely.

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